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FORTUNE

NEW DEBATE ABOUT HARVARD BUSINESS SCHOOL

It's still rich and famous, but is it training the right kind of managers?

Superstar professor Michael Porter: Scholar, teacher, consultant, millionaire

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FORTUNE

"I would never, ever become a full-time consultant. I would consider that ultimately terrible."

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"I perspire 99.9% of the time."

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"Have you noticed how much hugging is going on lately on Wall Street? We're checking to see if the other guy is bugged."

PAGE 97

"Some guys get their hair permed and go chase girls. I decided to start a company."

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"It's only recently begun to dawn on me the magnitude of what's happened to the North American gold industry."

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"Because of you and the Batra book I liquidated all my assets. And now here I am in the gutter."

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THE EDITOR'S DESK

ROB KINMONTH

Kiechel returned to his alma mater in search of truth about Harvard Business School.

THE BEST FORTUNE stories sometimes have strange origins. This summer Walter Kiechel, a member of our Board of Editors, was excerpting a book on Harvard Business School to run in the magazine when Dean John H. McArthur wrote to protest that the book was grossly unfair. No sooner had FORTUNE's researchers started checking the manuscript's facts than the publisher withdrew the book from our consideration.

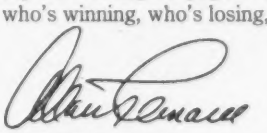
MICHAEL MOSE-LAYSUN

Taylor car-watching in Germany

But Kiechel's interest was already piqued. As a graduate of both the Harvard Business and Law schools (classes of '77), he knew that change was afoot at his alma mater. Despite the B-school's long-standing pledge to produce top-flight managers for U.S. industry, an ever-increasing number of graduates were heading for Wall Street, shunning line jobs at the major corporations America relies on for competitive strength. Many faculty members seemed tacitly to endorse the switch. Says Kiechel: "I wanted to know what had become of their commitment to train general managers."

Kiechel interviewed more than 30 members of the Harvard Business School staff and the deans of other leading institutions, while reporter Mark Alpert got the perspective of alumni who graduated five and ten years ago. The results make for a fascinating cover story.

To assess the future of the world auto industry, writer Alex Taylor III left his 1983 Toyota Corolla parked on a New York City street and set off on a six-country tour. That Taylor should have to travel so far says a lot about the world's largest industry. Despite protectionism, the business is becoming ever more global, and success will flow to those who design strategies to match. Taylor's nine-page report, starting on page 74, tells you who's winning, who's losing, and why.



EXECUTIVE EDITOR

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NEW DEBATE ABOUT HARVARD BUSINESS SCHOOL

The West Point of capitalism used to pride itself on turning out future CEOs. But now most of its MBAs head for Wall Street or consulting. What went wrong? ■ *by Walter Kiechel III*

Nobody has ever accused the Harvard Business School of being an ivory tower, a refuge for woolly-minded scholars out of touch with real life. No, this is a worldly institution and a great worldly success. It has produced scores of chief executives for America's leading corporations, including Ford, Johnson & Johnson, Xerox, and Colgate-Palmolive. Companies from six continents send their top people to its executive courses for just the right finishing, at prices up to $22,500 for the 11-week Advanced Management Program. Employers from Wall Street to Silicon Valley flock to Boston to hire recipients of the school's master in business administration degree, offering starting salaries that sometimes exceed $100,000 a year. Nearly 7,000 of the brightest college graduates in the U.S. compete for 800 places in each MBA class.

The professors, too, are a worldly crew. Mercedes and BMWs dot the faculty parking lot. A controversial new book, *The Empire Builders*, accuses the dons of grubbing for power and money in all sorts of unseemly

Insignia on the jerseys *of the Harvard Business School crew, which races other clubs on the Charles River, say it all about the students' goals.*

ways, such as using their positions to land consulting jobs and seats on corporate boards. Dean John H. McArthur denounces the "shabby, mean-spirited, and false manuscript" as being riddled with "hundreds of factual errors, invented quotations, and fabricated events." What the book does not attempt to do is address troubling questions about the school's role in fostering the competitiveness of American industry.

IN A FUNDAMENTAL way the Harvard Business School is growing more remote from corporate America: Increasingly its MBAs don't want to work there. Not in line jobs or for big companies, at any rate. This year, for the first time, an institution that has proudly proclaimed its mission as educating "general managers and business leaders," not "functional specialists or theorists," saw over half its graduating MBAs go into investment banking or management consulting (see chart). These two fields pay the highest starting salaries. Another 15% of the class headed off into venture capital, real estate, commercial banking, investment management, or other financial services. Less than 25% of 1987 MBAs took jobs with manufacturing companies, and most of these were staff, not line, positions.

A look at where graduates end up five or ten years out suggests that few subsequently move into the managerial mainstream. "Having just come back from my tenth reunion, I can say that essentially nobody from my class is on the path to running a large business," says a 1977 MBA who graduated in the top 5% of his class as a Baker Scholar. "The image of the business school is that it produces the captains of industry. But now it's producing the incredibly well-paid lieutenants of Wall Street."

A matter for concern? People like Donald Petersen, chief executive of Ford, think so. Petersen, a Stanford MBA, last year stirred a Harvard audience with his plea that the best and brightest seek leadership positions with America's big manufacturing corporations. Others point out that the largest industrial, retailing, transportation, and utility companies still account for more than two-thirds of the U.S. gross national product. If these enterprises are to fare well in the global competition, they will need the smartest possible managers at the helm.

But why blame the lemminglike defection of MBAs in pursuit of the dollar on Harvard? The same situation confronts virtually all of the best business schools, though not always in the same proportions. Isn't the real problem greedy students? In attenuated form Harvard seems to buy that argument. "I've had students who said they really wanted to go out and get line jobs," says Robert H. Hayes, an expert on manufacturing and coauthor of the famous 1980 article "Managing Our Way to Economic Decline." "Then salary offers came in. It's awfully hard for an MBA who is $20,000 in debt, living in shabby housing, and driving a clunky car to say to a spouse who has been working to support the family: 'I'll take the $40,000 job in Podunk, but I have an offer from Morgan Stanley for $60,000 with a $40,000 bonus.' "

Blaming the students seems too easy, though, a variant on the old Hollywood rationalization: "We can't be better managed because the inmates are running the asylum." The business school, after all, chooses who gets in, determines what students are taught, and sets standards for everyone at the institution. If any business school is capable of turning out managers, it should be Harvard. The school has more money (an endowment of $250 million), a bigger faculty (180), and greater celebrity than any competing institution. It also produces more MBAs (Wharton graduates about 750 each year, Stanford a mere 310). Perhaps most important, Harvard has long emphasized the practical nature of the education it offered, an emphasis embodied in its commitment to the case study method. While professors at other schools lectured on the latest theory of consumer behavior, say, Harvard had students tackle problems from the real world, dissecting cases that reflected the difficulty, and excitement, of being a manager.

At least that was how case study was supposed to work. Cases, which used to put students in a manager's shoes, now frequently read more like a finance text. This may explain something about why Harvard no longer turns out so many people inclined toward general management. Together with other changes, it also helps account for why an institution whose graduates include Martin Siegel and some of the smaller fry in Wall Street's insider trading scandals has yet to get its act together to teach about ethics, notwithstanding 60 years of faculty wrestling with the issue and a recent multimillion-dollar gift from John S. Shad, MBA '49, aimed at furthering the effort.

Dean McArthur says he is unworried by the trend in MBA placement, as it's known in the trade: "I think it's crazy where they're going, but we ought to just relax and enjoy it; it won't last long." McArthur, who used to be a finance professor, contends that the bubblelike expansion of investment banking houses, which has sucked so many MBAs into Wall Street, can't continue.

BUT OTHER strong trends are at work here. To a degree, Harvard influences the career choices of its graduates more than two years earlier, when it culls those 6,800 applicants down to the fortunate 800. The business school increasingly requires real-world job experience from the people it admits, and almost no one gets in straight from college anymore. The median age of this year's entering class is 26.1, up from 25.8 last year. In the school's view, these more seasoned types will be better able to resist the stampede to high-dollar jobs.

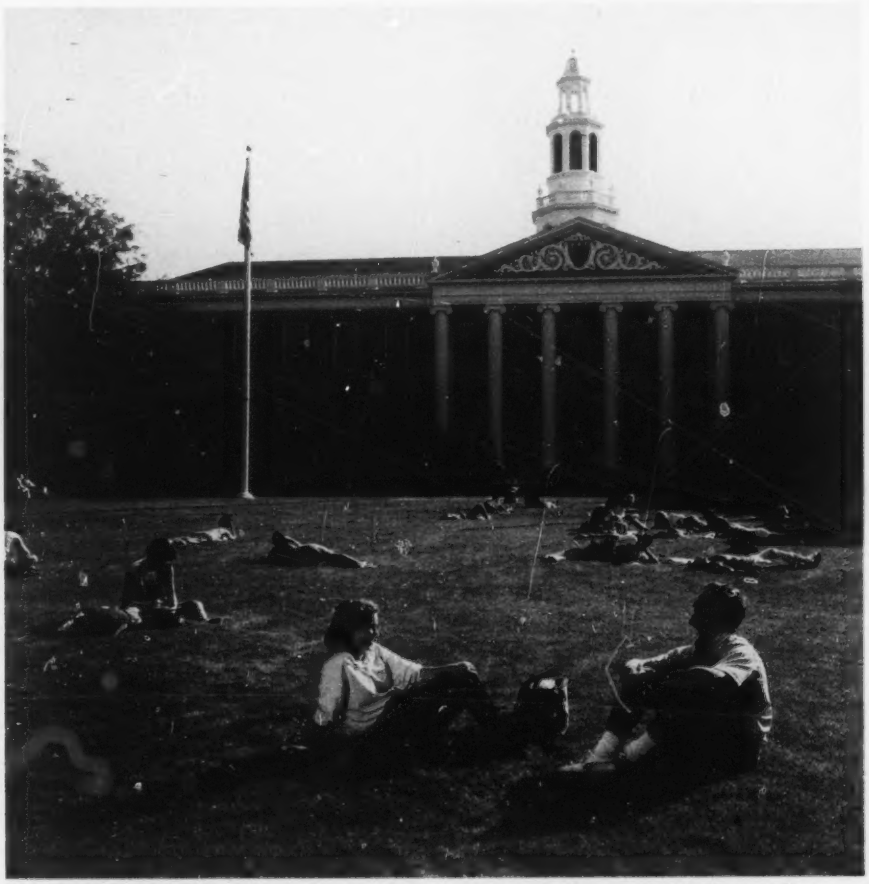
What school officials don't talk about as much, however, is where the students obtained their job experience: In 1987 nearly a quarter of the new class came from investment banking houses or management consulting firms. In recent times these outfits have heavily recruited undergraduates from prestigious colleges, put the new hires to work crunching numbers in jobs with a title like "research analyst," and

Dean John H. McArthur *isn't worried.*

REPORTER ASSOCIATE *Mark Alpert*

PHOTOGRAPHS BY ROB KINMONTH

then coached them on how to get into business school. So developed has the practice become that a former Stanford Business School admissions director, Kathleen Gwynn, has started a company devoted to counseling analysts on, for example, how to write a business school application. Her principal accounts: First Boston, Goldman Sachs, and Bain & Co., the Boston-based consulting giant.



Uncharacteristically relaxed, *students bag a few autumnal rays in front of Baker Library.*

When the former analysts arrive at Harvard, they and their new classmates encounter a recruiting blitz spearheaded by—who else—investment banks and consulting firms. The first offer is usually a summer job. The next year it's a permanent position, with a nice signing bonus attached. The word that drops from the lips of just about every faculty member in describing the competition among employers is "frenzy," as in "feeding frenzy." But Harvard isn't doing as much to curb the madness as some competing institutions.

The business school student newspaper recently carried advertisements for three upcoming speeches on campus by top investment bankers—two inviting "interested students" to receptions afterward—three ads announcing appearances by management consultants, and one full-page declaration that Booz Allen & Hamilton "looks forward to meeting first-year students" at a series of cocktail parties at a nearby hotel. This was the third week of the first semester. By Christmas, says one of Harvard's senior associate deans, the recruiting companies "know 500 students; they know our students better than we do."

Employers may also know that fully 30% of graduating MBAs go to work for the same outfit that gave them a summer job between first and second year. Through the end of one school year and into the next, the pressure on students builds, as the tom-toms tell of spectacular offers made to classmates. By the time spring of the second year rolls around, which ten years ago was the official recruiting season, the action is pretty much over, as some would-be employers have discovered to their dismay.

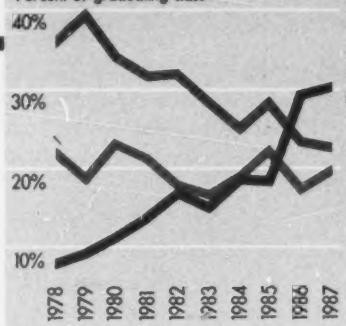
What does the business school get from all this, aside from a big challenge in keeping students faintly interested during their last months? Every year the placement office surveys members of the graduating class about their jobs. The glossy brochure, showing who goes where and the median salary graduates command in each industry, is given wide circulation. Presumably the eye-popping salaries encourage similarly superior individuals to consider applying to Harvard.

But the business school has a much more direct interest in seeing its students earn a lot of money. As recently as the early 1970s, it was hobbling along with an endowment of $30 million and maybe $1 million in annual gifts. In the interest of breaking even, the school began to rethink its fund raising, or the lack of it. Shortly after he became dean in 1980, McArthur put Professor Hugo E. R. Uyterhoeven in charge of fund raising. Uyterhoeven made such a success of it that around $18 million in gifts will come in this year, vs. about $4 million in 1980. Recalls Uyterhoeven: "We decided to go the alumni route. We found that companies aren't all that generous." The secret to alumni giving, the business school discovered, is tapping reunion classes, particularly the 25th reunion class, and the key to this is enlisting alums who give generously themselves and can put the arm on others to do likewise. Every 25th reunion class since 1980 has had an investment banker or a management consultant as its chairman or gift chairman.

A COLLAPSE in hiring by investment banks—or I-banks as some me-generation types on campus call them—thus might have repercussions that reach far beyond placement. Is such a collapse inevitable, as McArthur suggests? You can imagine the scenario: Financial markets decline, merger activity cools off, margins contract, and all those blue-suited gunslingers in lurid suspenders finally get what's coming to them.

Certain trends suggest, however, that even if investment banking suffers hard times, the hiring of top-flight MBAs may not fall off that dramatically. Investment banking looks increasingly like a new-products game. Who better to come up with the next winky-doo-backed security than a newly minted MBA, full of the latest financial esoterica and churning with ideas? Moreover, management consultants have learned that if they

WHERE THE MBAS WENT AND . . . HOW MUCH THEY MADE



First-year salary (1987 dollars)

	1978	1987
Investment banking	$38,828	$50,100
Manufacturing	$39,545	$45,627
Management consulting	$49,567	$62,300

Many more picked careers in investment banking, at the expense of jobs with manufacturing companies. Consulting held its own. Salaries are medians of what students got, except for manufacturing, where they are averages. Bonuses often raise the starting salaries of investment bankers to $70,000 or more.

want to keep hiring Harvard MBAs, they must never, ever, lay off recently recruited graduates. Better to prune the tree further up, at the third- or fourth-year associate level. Despite ups and downs in the business, consulting's share of Harvard's graduating MBA class has hovered around 20% for ten years.

Harvard is already taking steps to correct the skew in its admissions policy, in ways that may eventually affect where students go. Two years ago it stopped requiring the GMAT, the business school equivalent of college boards, in part to reduce the importance of how adept an applicant is with numbers. Laura Fisher, the new admissions director, talks about the need for "strategic diversity" in making up an MBA class, and Harvard has begun to put out word on college campuses that analyst's programs are no longer the royal route to you know where. In fact, the school hints, it may limit the number of people it takes from such programs.

Some faculty members say they have tried to steer students away from the chase after money. "Our faculty is outrageous in what it says about Wall Street," observes Professor Joseph L. Bower, a senior associate dean. The problem is not what the professors say but what they do: Some are in fairly hot pursuit of money themselves. Knowledgeable critics of Harvard tell a story about a former professor there. Every year the man would be pictured in the faculty directory against a backdrop of empty bookshelves. If you visited his office, the story goes, you would find that it too was apparently unused: The professor was spending so much time on moneymaking activities outside that he was almost never there. Finally the dean, one of McArthur's predecessors, gave him a choice: Cut back on the outside stuff, or leave. He left.

The problem, or what faculty members prefer to call the "inevitable tension" between work inside the school and work outside it, continues. The business school pays senior professors as much as $112,000 a year, plus another two-ninths of their salary if they work over the summer. In their spare time they can earn considerably more than this. Some do, including Professor Michael E. Porter, probably the faculty member best known outside the school (see box).

Most of the faculty's outside work falls into one of four categories: consulting, teaching in corporate training programs, testifying as expert witnesses, or serving on corporate boards. Of late, teaching has become the hot ticket; a senior professor can command over $5,000 a day for teaching a corporate audience essentially the same cases he does back at Harvard.

In 1983 McArthur set up a faculty committee to review the school's guidelines on

The world's largest library of business *takes its name from George F. Baker, the school's first big donor and a friend of J. P. Morgan.*

outside activity. The committee recommendations, submitted a year ago, begin by affirming existing policy, the first principle of which is "A certain amount of consulting is good"; it keeps professors in touch with the business world and may uncover situations that can be written up as cases. The report goes on to express concern about the lopsided distribution of outside activity across the faculty. In a survey three years ago, 20% expected to do less than 15 days of consulting, not enough in the eyes of the committee. On the other hand, 10% expected to do 40 or more days—40 being the maximum supposedly allowed. The report advises caution in taking corporate teaching assignments. But it recommends leaving the limit at 40 days a year, even though a survey of the faculty revealed that 85% believed tenured professors do too much outside teaching. Other recommendations: Clarify reporting of outside activities and have faculty members discuss with the dean any tough cases, such as the opportunity to serve on more than four

THE CASE OF MICHAEL PORTER, SUPERSTAR

■ Professor Michael Porter, 40, exemplifies much of what's best and some of what's troubling about the Harvard Business School. He is an engaging teacher, an indefatigable researcher, and a fount of ideas that appeal to managers. He has also never been reluctant to make a buck from those ideas, in ways, critics charge, that sometimes detract from his role as a professor.

The son of a U.S. Army officer, Porter earned an undergraduate degree in mechanical and aerospace engineering from Princeton, where he was an NCAA all-American in golf. He went on to take an MBA from Harvard (high distinction, Baker Scholar) in 1971 and then, in 1973, a Ph.D. from the department of economics across the river. He joined the business school faculty that year, and became a full professor in 1982, not without opposition from old-line faculty members who were uncomfortable with his work.

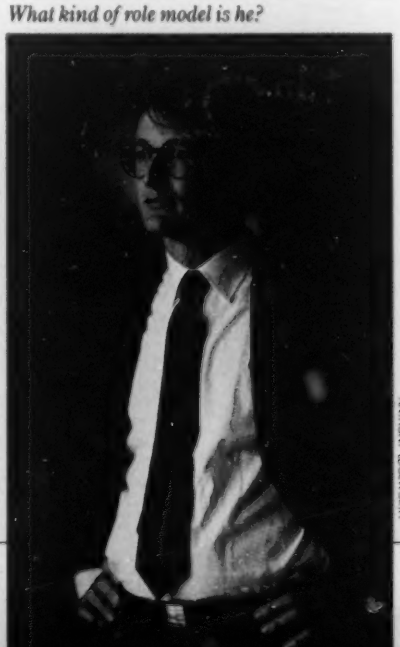
What Porter does is to examine corporate strategy from the perspective that earned him his economics Ph.D. Why does one player in an industry come out a winner, another a loser? Porter's writings abound with concepts that can be used to analyze a company's competitive situation—for example, the successive steps by which a business creates value. His courses have consistently been among the most popular at the business school, and his books are a big hit too. *Competitive Strategy*, published in 1980, has sold well over 200,000 copies; sales of *Competitive Advantage*, published in 1985, are about 120,000.

Celebrity—and wealth—came on the heels of *Competitive Strategy*. "What people forget," Porter says, "is that until 1980 I didn't get any calls. I spent seven years holed up in the library doing research." Then his phone began to ring, and ring, as companies sought his advice. Because he didn't want to manage his own consulting business, Porter worked, or tried to work, with a succession of firms. "I would negotiate how an assignment was going to be done," he explains, "but then the people working on it would go off in their own direction."

A frustrated Porter saw a chance to call more of his own shots in 1982, when a faculty colleague, Mark Fuller, decided to leave Harvard to start a consulting firm. Fuller asked Porter to become a principal in the Monitor Co. (or TMC), and Porter agreed, on certain conditions: "I was to have no administrative role. I wouldn't go to meetings. I would not recruit a single person; in fact, I told Mark that he couldn't tell anyone I was involved. And I said I would never meet with any students about TMC."

Largely on the strength of Porter's contacts, TMC took off. It now has about 175 professionals in five offices around the world. Clients include AT&T, McGraw-Hill, and Italy's Montedison. Porter says that he participates in "major meetings," provides "conceptual direction," and exercises "quality control," reviewing the efforts of consulting teams.

What kind of role model is he?



HUGH KOBEL ANTHONY

And how does all this square with the business school's strictures on outside activity? Porter adamantly maintains that he abides by the rules, devoting only 20% of his time to outside work. The tougher question may attach to a provision of the guidelines that cautions faculty members against any managerial or ownership positions "representing a substantial portion of one's net worth." While Porter won't talk about his compensation from TMC, consultants at other firms estimate that a person similarly situated might easily make $500,000 a year. When asked about the net worth test, Porter, who was on the faculty committee that reviewed the guidelines, replies: "When I started with the firm, it wasn't worth anything." Would he ever leave academe to work at the business full time? "I would never, ever become a full-time consultant. I would consider that ultimately terrible."

Porter, whom one colleague described as "a prime candidate for burnout," will return to the classroom next spring, after a generous 18-month vacation from teaching. He has hardly been idle during that time. He served, for free, on the President's Commission on Industrial Competitiveness, and he has been doing research for a new book on the competitive strengths of different nations.

The peripatetic professor shows few signs of slowing down, even though his wife gave birth last summer to their first child, a daughter. The only thing that bothers him, he says, is the carping of other faculty members, or, as he puts it, "people bitching and moaning about things that are irrelevant." Sometimes the sniping gets so bad he goes to talk to his friend John McArthur. With a laugh, Porter recounts the dean's advice: "John just says: 'Hey, throttle back, do a half-assed job, and it'll stop.' "

HARVARD BUSINESS SCHOOL'S 1987 CASH FLOW

SOURCES in millions		USES in millions	
Endowment income	$30	Instruction	$40
MBA tuition	$27	Additions to endowment	$30
Executive program fees	$23	Research & development	$25
Publications	$22	Publications	$20
Gifts	$18	Renovation	$5
New debt	$0	Student loans	$0
TOTAL	$120	TOTAL	$120

The school moves in and out of the debt markets but didn't borrow this year. Funds for research go 40% for developing cases, 60% for straight scholarly work. In 1987 the payback from student loans equaled money lent out.

boards at once. Properly handled, all this "will permit professors ... to earn income supplementary to University salaries that will permit a good standard of living."

Ten years ago a joke among students had it that certain professors used their faculty salary to pay a small portion of their tax bill. These days some MBA candidates want to emulate their professors. They hope, for example, to go to work for a consulting firm that Michael Porter helps run. But who on the faculty holds up the example of the general manager? "We all do," say a surprising number of professors, "in the cases we teach."

Their answer barely skims the surface of another profound change at the business school. Who are these professors and what do they talk about in the classroom? In the old days faculty members came up through the ranks of Harvard's doctor in business administration program. But as bright MBAs increasingly chose high-paying jobs over graduate study, that pipeline pretty much dried up. The number of new students seeking the DBA has dropped from 60 a year in the 1970s to nine or so recently. And McArthur faces the necessity of replacing a third of his senior faculty in the next decade.

In response he has taken several steps. He has brought in eminent faculty members from other business schools and given them full professorships. He has set up joint Ph.D. programs, working, for example, with the departments of psychology and sociology to develop a Ph.D. in organizational behavior. Increasingly too he has gone outside to recruit Ph.D.s in the business school disciplines—marketing, say, or finance.

WHAT ALL of this translates to is a faculty that is more discipline based, more focused on scholarship in a particular specialty than in writing cases. Aspirants to tenure, instead of getting a Harvard MBA and then serving an apprenticeship developing cases under a senior professor, today are more likely to have started out producing scholarly articles for the *North Frisian Journal of Theoretical Microeconomics.* During their perilous navigation of Harvard's tenure track—only two or three out of ten make it—they understandably want to keep their scholarly credentials up to date, against the day they have to seek employment at another business school, most of which emphasize the disciplines even more than Harvard.

Cases are still the basis of class discussion at Harvard, and new faculty members are still given considerable coaching in how to teach them. But to use case writing as a primary means of research, to devote months to trying to capture all the twists and turns of an actual manager's experience? That won't get you anywhere in a discipline-based world.

Cases themselves have changed as a result. Classically they began with a manager in a tough spot ("Lemington Burford sat in his darkened office and reflected on the events that had brought his company to this sorry pass") and ended with a pointed question ("What should Burford do?"). The teacher led students through an aggressively Socratic dialogue—"You think he should cut production? But if he does, what about ..."—that required them to back up their recommendations with reasons. Done right, the experience offered an exhilarating

Executive education programs *make Harvard a lot of money and often result in consulting jobs for business school professors.*

sense of what it was like to be a manager.

Cases now more frequently look like what once would have been considered background material—a description of a theory, a list of procedures, someone's framework for analysis. ("Burford wondered whether the capital asset pricing model might not be appropriate here. The capital asset pricing model is . . .") Asked how his approach to cases has changed, a marketing professor replies: "I've learned to write technical notes that look like cases."

The evolution of case studies has in turn affected the school's curriculum. For as long as anyone can remember, Harvard's courses have mostly bubbled up from its faculty's interests: A professor would become intrigued by something and do research on it. If he stayed interested, he or a researcher might write cases on the subject, which might serve as the readings for a new second-year elective course. If the course proved popular with students—and Harvard's faculty is extremely market driven in this respect—bits of it might make their way into a required first-year course.

What MBA candidates have wanted of late are financial formulas, mathematical models, and analytical tools—the kind of stuff consultants and investment bankers use. In the past ten years such materials have made their way into the classroom and altered the curriculum. Consider, for example, how Business Policy I turned into Competition and Strategy.

Ten years ago BP I, as it was known, was the only required course in the first semester of the second year. It treated corporate strategy, in the genteel tradition of those days, not as a set of formulas but as the mission of the company, its distinctive competence, reflecting the values of its managers. The course was not particularly popular.

About this time a young assistant professor named Michael Porter, the ink still relatively damp on his Harvard Ph.D. in the economics of industrial organization, wrote a technical note "On the Structural Analysis of Industries." The note became assigned reading in BP I, "as a way of making the process more rigorous," Porter says. He then went off to teach in one of the executive programs and began writing cases. These, centering on concepts such as "barriers to entry" (high start-up costs, say, or established brand names), formed the underpinnings of a second-year MBA elective he introduced in 1977, Industry and Competitive Analysis. It was an immediate smash, in some years attracting 400 students. Ideas from the course began filtering into BP I.

Rosabeth Moss Kanter *left the faculty at Yale to teach at Harvard.*

Finally, in 1983, McArthur persuaded Porter to take over Business Policy I, which had been shifted to the spring of the first year. Porter describes what happened next: "I took out all the material on the general manager, and on the values of society and the manager. It became a course in strategy, not in general management." All that remained was for BP I's name to be changed, which happened in 1986.

So what if Harvard isn't turning out MBAs who will become general managers? As Professor Joe Bower points out: "A lot of restructuring is being done by consultants," not to mention investment bankers. Many of the consultants will eventually become venture capitalists, investing in and helping to guide new enterprises. Some faculty members think that is just nifty. Says Rosabeth Kanter, an expert on the often hidebound ways of large corporations: "Some large companies are still so bureaucratic that I'm not sure I could recommend that my students go to work there." Or, as another Baker Scholar, class of 1982, puts it: "This captain of industry stuff—is he a person willing to work for 30 years to be chairman of GM and deal with the bull—?"

Yes, as a matter of fact. Also, increasingly, the person who tries to cut through the bull at GM and change the hidebound ways. Harvard Business School professors talk and write eloquently of the challenges facing business: globalization, an accelerating succession of new technologies, the need to manage organizations of unprecedented scale. But who, in 20 or 30 years, will be responsible for meeting these challenges at the largest companies, at the end of the day, when the people in blue suits have flown back to New York or Boston? Probably not Harvard MBAs, unless the business school rededicates itself to its historic mission. F

Michael Jensen, *another transplant, still teaches at Rochester too.*

COMPETITION

WHO'S AHEAD IN THE WORLD AUTO WAR

Ford is up, GM is down, Honda is charging and—what's this?—Peugeot is coming from nowhere. ■ *by Alex Taylor III*

ITS MOST CELEBRATED executive is an American (Chrysler's Lee A. Iacocca), its most prestigious brand is European (Mercedes-Benz), and its most feared competitors are the Japanese (many of them). Once as provincial as a neighborhood Chevy dealer, the world's biggest industry is increasingly global in scope and—contrary to yesterday's conventional wisdom—growing ever more diverse and complex. Some 175 automakers now produce more than 45 million cars, trucks, and buses a year, often shipping them to customers halfway around the globe. The sales add up to something like $384 billion a year—2.1% of the world's GNP.

Though protectionism keeps the war from being the free-for-all it should be, success now belongs to companies that plan and execute strategies for the world. Mired in North America, where it is steadily losing ground, General Motors is struggling to develop such a strategy, while archrival Ford Motor Co. is reaping the benefits of its long years as an overseas power. Fast-rising Honda plans to use Ohio as the base for exports to other parts of the world, including its home country.

The new internationalism has created a golden age for car buyers everywhere. As they shop the world, they are demanding and getting ever better design, performance, and comfort. The most successful manufacturers today build cars with Japanese quality and European-style handling that coddle their passengers in the mass-market opulence America pioneered. With the heavy slogging on fuel economy and exhaust emissions behind them, engineers are delivering advances in technology that enhance drivability, handling, performance, safety, and, yes, further fuel economy. Among them: multivalve engines, increasingly sophisticated electronic engine controls, antiskid braking, and automatic electronic suspensions.

So today Japanese queue up to buy some 15,000 BMWs a year, enough to make the German luxury car the second-best-selling import in Japan after Volkswagen. Europeans cannot get enough Jeep Cherokees, produced in Toledo, Ohio (10,000 were sold to them last year). In the U.S., Pontiac's hottest-selling car is the LeMans, a version of the Opel Kadett designed in Germany and built in Korea (1988 estimated sales: 110,000). Sweden's Saab and Volvo attract a loyal core of well-heeled enthusiasts, as do other low-production makers of high-class automobiles in Britain, West Germany, and Italy. And the car that U.S. customers find most satisfying to own is a luxury Japanese brand that made its debut only 18 months ago: the Honda Acura (see table).

No one was predicting this abundance a few years ago. Autophobia was ascendant, and a gloomy consensus prevailed about the future of the industry in an energy-short world. Everybody would be driving spartan econoboxes. Competing on price in a commodity market, high-volume manufacturers would enjoy indisputable cost advantages. The 20 or so leading automakers would be subsumed into a half-dozen megaproducers churning out "world cars"—look-alike vehicles for customers from Ypsilanti to Yokohama.

Instead the competitors have remained many, and if anything, sheer size seems less of an advantage than it used to be—or sometimes even a hindrance. Prosperous and freed from worries about gas shortages, car buyers once again indulge their passions for style, speed, gadgetry, and panache. Fortified by this demand and prodded by new competition to get costs under control, the industry recovered quickly. Today the world's major automakers are by and large far stronger than they were only a few years ago.

They will need that strength and more in years to come. For carmakers, unlike consumers, the golden age is likely to be fleeting. Last year some 488 million vehicles roamed the earth. Western Europe was the biggest producer, followed by the U.S. and Japan. But the worldwide total also includes

MICHAEL WOLF—VISUM

Shopping the whole world *in an increasingly*

REPORTER ASSOCIATE *Stephen J. Madden*

ecumenical auto industry, these Germans scrutinize a Mazda RX-7 Turbo at the Frankfurt auto show. Japan won 18% of West Germany's market in August.

42,116 Otoyal & Tofas from Turkey, 22,022 cars carrying the name of Hindustan Motors in India, and 13,870 built by Yue Gyan Machinery Manufacturing Co. of Taiwan.

BY THE 1990s there will be far less room for new cars than manufacturers would like. Automakers are not retiring old factories as quickly as they add modern ones. Europe can already build about two million more cars a year than it needs; so can Japan. Assuming as most experts do that demand will grow 1% to 2% a year, the glo[illegible]all soon be awash in production capacity. GM Chairman Roger Smith, who pays attention to these things since GM accounts for 18% of the world's auto production, worries that overcapacity will reach six million units by 1990 and perhaps go as high as seven million. The U.S. alone will have 2.5 million units of unused production capacity. That is enough empty factory space to build as many cars as Ford does.

Even those figures are low if social, economic, or ecological trends develop adversely. Researchers at Volkswagen, for instance, worry about what happens if highways collapse in paralyzing congestion—it may be happening already in Los Angeles—or whether thousand-year-old European cities can stand any more traffic at all. More imponderable but perhaps also more likely: What will be the effects of the next oil shortage and what will happen to gas prices?

Not everyone agrees that growth will be limited. Toyota President Shoichiro Toyoda, for one, expects new technologies and sharp competition to bring prices down and stimulate more demand than expected. Interviewed recently in Toyota City, he predicted that the worldwide market will grow 2% to 3% a year. Though Toyoda's projections ap-

THE WORLD'S TOP 20

AUTOMAKER Headquarters	1986 UNIT SALES 10-yr. growth rate	WORLD MARKET SHARE	PRICE RANGE	WHERE THEY BUILD N. AMERICA · S. AMERICA · W. EUROPE · E. EUROPE · AFRICA · ASIA · AUSTRALIA/N.Z.	HOW THEY ARE DOING
GENERAL MOTORS United States	**8,163,438** −1.0%	18.1%	$5,495- 56,533	■ ■ ■ ■ ■ ■ ■	Broadest price range, but venerable policy of "a car for every pocketbook" has not preserved sales.
FORD United States	**5,984,081** −0.9%	13.3%	$6,586- 26,008	■ ■ ■ ■ ■ ■ ■	About 40% of production in high-profit trucks. Global plans depend on tricky engineering coordination.
TOYOTA Japan	**3,689,212** 3.1%	8.2%	$5,848- 23,810	■ ■ ■ ■ ■ ■ ■	Controls 42% of home market. World leader in high-output multivalve engines, installed in all Corollas.
VOLKSWAGEN West Germany	**2,757,793** 7.2%	6.1%	$5,690- 23,090	■ ■ ■ ■ ■ ■ ■	Golf more popular than ever in Europe, but flounders in U.S., where the cars are considered expensive.
NISSAN Japan	**2,700,000** 0.77%	6.0%	$6,499- 18,199	■ ■ ■ ■ ■ ■ ■	First Japanese company with plants in U.S. and Europe, recovering from long slump.
CHRYSLER United States	**2,198,415** −0.6%	4.9%	$5,499- 14,910	■ ■ ■ ■ ■ ■ ■	Negative ten-year growth masks turnaround of the decade. Gets a big lift from minivans it pioneered.
PEUGEOT France	**1,724,200** 8.2%	3.8%	$5,100- 23,750	■ ■ ■ ■ ■ ■ ■	Its recovery has astounded European competitors, but it hasn't yet boosted U.S. sales beyond 20,000.
HONDA Japan	**1,582,000** 9.0%	3.5%	$6,095- 28,291	■ ■ ■ ■ ■ ■ ■	Fastest-growing in top ten; phenomenal entry into luxury market with Acura. Not yet strong in Europe.
RENAULT France	**1,574,964** 1.2%	3.5%	$6,399- 12,899	■ ■ ■ ■ ■ ■ ■	Now profitable but frogile; abandoned U.S. manufacturing dream. French government may sell it.
FIAT Italy	**1,476,422** 2.3%	3.3%	$4,585- 21,000	■ ■ ■ ■ ■ ■ ■	Has 60% of Italian market. Trying to revive Lancia, develop Alfa-Romeo as performance car for export.
MAZDA Japan	**1,405,170** −1.5%	3.1%	$5,999- 24,425	■ ■ ■ ■ ■ ■ ■	Leading Japanese import in West Germany. Unique Wankel engine powers RX7 sports car.
MITSUBISHI Japan	**1,270,700** 5.0%	2.8%	$3,571- 30,714	■ ■ ■ ■ ■ ■ ■	Blurred image in U.S. because of distribution through Chrysler dealers as well as own. Quirky styling.
LADA U.S.S.R.	**1,100,000** −1.5%	2.4%	$4,198- 5,344	■ ■ ■ ■ ■ ■ ■	One-quarter of production exported. New model, replacing 20-year-old Fiat design, due in 1988.
SUZUKI Japan	**900,746** 14.1%	2.0%	$3,103- 9,551	■ ■ ■ ■ ■ ■ ■	U.S. sales of its Jeeplike $8,000 Samurai are booming. Will build minicars with GM in Canada by 1989.
FUJI (SUBARU) Japan	**634,000** 10.1%	1.4%	$5,700- 17,500	■ ■ ■ ■ ■ ■ ■	Sales of its Subarus have been hard hit by rising yen. U.S. plant, built with Isuzu, will open in 1989.
DAIHATSU Japan	**592,599** 6.4%	1.3%	$3,393- 15,834	■ ■ ■ ■ ■ ■ ■	Competes at low end against Third World cars. Ninth and last Japanese carmaker to enter U.S. market.
DAIMLER-BENZ West Germany	**591,000** 0.13%	1.3%	$27,430- 70,600	■ ■ ■ ■ ■ ■ ■	Cars favored by the wealthy in the U.S., taxi drivers at home. Some 25% of sales from trucks and buses.
ISUZU Japan	**526,244** 4.5%	1.2%	$7,459- 14,919	■ ■ ■ ■ ■ ■ ■	Has won distinction in U.S. with wry ad campaign that makes patently impossible claims.
ROVER GROUP Britain	**472,490** −1.2%	1.0%	$6,557- 31,148	■ ■ ■ ■ ■ ■ ■	Last British mass-producer; best-selling Metro designed by Honda. Lost money pretax for eight years.
BMW West Germany	**446,109** 4.5%	1.0%	$23,180- 55,950	■ ■ ■ ■ ■ ■ ■	Only pure luxury manufacturer in top 20. Expensive new models selling very well in U.S.

BEST-SELLING MODEL (UNIT SALES)
Base price

pear optimistic, some other experts foresee similar trends. In the U.S. particularly, says David Fubini, a McKinsey & Co. automobile strategist, "excess capacity will bring significant price pressure to bear on all market segments except the highest end."

The majority remain unconvinced of the falling-prices, rising-demand scenario. Their views are expressed in the *Delphi IV Forecast and Analysis of the U.S. Automotive Industry Through 1995*, the latest in a series published every three years by the University of Michigan's Transportation Research Institute. Looking at the U.S. market, the more than 225 auto executives, academics, and other experts polled conclude that the median retail sales price of a U.S.-made car in constant 1986 dollars will rise 19% from 1985 to 1995, to $13,800. Imports will move up to a median of $14,700 from $12,600.

One factor behind the climb will be increased use of high-technology components. Another: consumer demand for large and sporty cars. Researchers such as James Womack at MIT add that manufacturing technology takes a long time to pay off in lower production costs, and that carmakers will continue to turn out cars laden with options. To be sure, at the low end of the market increased U.S. production by Japanese manufacturers will help hold down prices—even as cars from South Korea, Mexico, and Brazil provide price discipline for the Japanese. But the Delphi group foresees nothing that would raise the growth of world demand above 2%.

If the consensus view proves correct, the next decade will be difficult indeed for established manufacturers. The Delphi group, for example, figures that size alone will keep General Motors at the top of the world's automakers, though the company's output will shrink from 6.1 million cars in 1984 to six million in 1995. Ford and Chrysler will gain ground, but not as much as three Japanese companies: Toyota up 17%, Nissan up 22%, and Honda Motor up 55%. Honda, at 25 the world's youngest major car producer and the eighth-biggest, could vault past Chrysler into the ranks of the top six, close on the heels of Nissan and Volkswagen.

Five years ago auto experts were waiting for less developed countries to burst into the world car market like little Japans. They are still waiting. The major producers have had some success building cars for export in Mexico and Brazil, but native automakers are struggling. With a list price of $3,990, the Yugoslavian-built Yugo meets only minimum standards in the U.S. for performance and quality, and only some 40,000 have been sold this year. As an MIT report points out, less developed countries cannot easily leap into the world arena as producers of high-technology components. And aside from low wages—which will become increasingly unimportant as automakers automate—they have no special advantage.

Even Korea's Hyundai, which sold 261,392 cars in the U.S. last year, is limited. Hyundai is scrappy—it sent 20 engineers to the Frankfurt auto show this fall to evaluate the competition—but its executives concede that the in-house engineering and supplier network it needs to develop export models beyond its current offering is lacking. Mitsubishi supplies its car designs, and such vital components as air conditioners and tires come from overseas suppliers.

The Third World may yet become an important market. Analyst Maryann Keller of the investment bank of Furman Selz Mager Dietz & Birney thinks that new producers in Asia, South America, and Eastern Europe will be making 20.4% of the world's cars by 1997, up from 12.5% in 1986. But few of the vehicles from Asia and South America will be sophisticated enough to sell in the West, and the home markets in most less developed countries are, well, hard to develop.

YESTERDAY'S received wisdom has also fallen short in its prediction that Western Europe's old-line manufacturers, doddering in the early part of the 1980s, were falling behind the rest of the world. Buoyed by a strong economy, they set a record in 1986 by making 12.8 million cars and are headed for 13 million this year, not to mention unprecedented profits. Fiat, which has worked out its problems with Italy's fractious labor unions and is now Europe's low-cost producer, is jousting for leadership with Volkswagen, the world's leader in assembly line automation. Even such chronic money losers as General Motors of Europe and Renault will show a profit this year. Penny-pinching Jacques Calvet, Peugeot's colorful boss (see box, page 86), has brought his company practically back from the dead. Peugeot is more than a million units behind Volkswagen right now, but Calvet promises that it will be Europe's leading producer in five years. He also plans to more than triple sales of its higher-priced cars in the U.S.

The Europeans' success owes as much to protectionism as to industriousness and ingenuity. Japanese imports are limited to 2,500 a year in Italy and only 3% of the market (about 57,000) in France. Even so, Japanese cars now account for more than one in

every ten sold in Europe. Only the Germans give the Japanese virtually free access, and the results are disconcerting even to these aristocrats of the auto industry: Japan grabbed 18% of the German market in the month of August.

By 1992 the remaining trade and tax barriers between Common Market countries are to be dissolved. European automakers will be competing more vigorously than ever with each other. But the Japanese are not likely to be granted equal privileges. VW Chairman Carl Hahn said recently, "I consider simply opening the market unnecessarily dangerous, given the excess global capacity."

The betting is that informal barriers, similar to those that exist in the U.S., will be erected to limit Japanese imports. So the Japanese company best positioned is Nissan, which got a head start over its countrymen by building a plant in England that will turn out 100,000 Nissan Maximas by 1991. Maryann Keller, however, suspects other Japanese producers may try to use Eastern Europe as a low-cost assembly base, avoiding the barriers. She thinks the Common Market countries will be slower to restrict vehicles built in their own backyards.

IN THE NORTH AMERICAN market, everybody's favorite battleground, the Japanese will have erected ten plants producing 2.5 million cars by 1990, either separately or in partnership with U.S. companies. That's the equivalent of adding another company twice the size of Chrysler. But it's GM that has the most to lose. Its market share has fallen to 37% from 42% just a year ago, and the Delphi experts figure the company will be fortunate to hold that much even if it succeeds in slashing bloated costs and making better cars.

GM's main problem is that its enormous size has become a hindrance rather than a help. It alone among the world's automakers offers a full range of models in five different lines. No other company has more than two, and Toyota, GM's biggest Japanese competitor, has only one. Acknowledging that confusion among car buyers about the differences between, say, a Chevrolet and a Pontiac, has depressed sales, GM has been trying to create separate identities for its different divisions.

The company's size no longer gives it the leverage of manufacturing efficiency. Relying on the assumed advantage of vertical integration, GM makes about 70% of the parts it uses in its cars, but it has found that rivals can buy from suppliers with lower costs and often higher quality. According to John Krafcik, an analyst for the international automotive program at MIT, the weaknesses became embarrassingly evident when GM began making cars two years ago with Toyota in Fremont, California. Initial shipments of wiring harnesses from GM's Packard Electric Division were unusable, and Packard had to station an engineer at the plant full time to correct the problems. Krafcik says other GM-owned parts makers were suspected of treating shipments destined for the Fremont plant with special care in segregated areas using handpicked workers. So GM may have been in the odd position of treating its own divisions worse than the joint venture.

Meantime other automakers are learning how to make profits on short production runs, spinning out cars at low volumes to satisfy a variety of tastes. Chrysler, for instance, can build four different cars at its Sterling Heights, Michigan, assembly plant, which has a capacity of 250,000: the Chrysler LeBaron GTS, the Dodge Lancer and Shadow, and the Plymouth Sundance. The key is using flexible manufacturing techniques in order to develop what are known as economies of scope—the capacity to satisfy diverse customer wishes without adding new facilities.

Automakers are finding varied ways to be flexible. Japanese manufacturers emphasize programmable robots that can do different tasks. At Honda's teeming plant in Sayama, one hour from Tokyo, for example, cars are assembled with steering gear on either the right or left side without upsetting the production flow. In Europe, France's Peugeot and GM's Opel are enthusiastic boosters of automatic guided vehicles, known as AGVs. These electrically powered devices trundle partially completed cars individually from one workstation to another, allowing plant managers to design a day's assembly schedule in units of one rather than blocks of 100.

To make the most of their resources, automakers are increasingly linking up with other producers to develop new technologies, components, or even cars. Volkswagen secures such ventures with the sure-handedness of a Lothario. It now has ties to no fewer than 11 other companies, including Nissan, Volvo, Daimler-Benz, and Porsche. Its latest, 75% ownership of SEAT, the Spanish manufacturer, gives it an advantage in one of Europe's last uncrowded markets.

Only Honda, among the world's major automakers, shuns alliances. It has just one, an arrangement to design cars with England's Rover Group. Honda President Tadashi Kume (see box, page 88) insists that

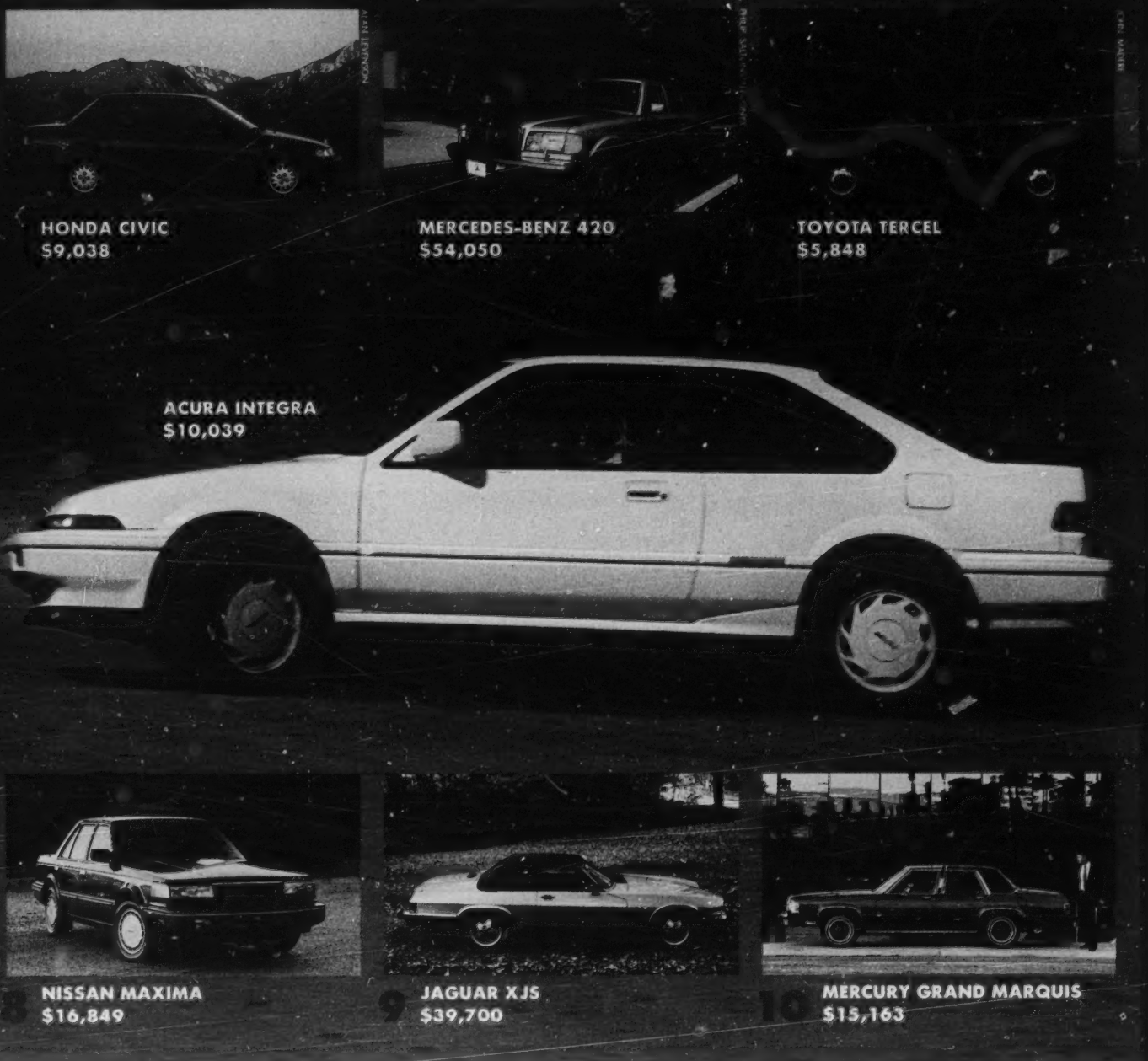
THE CARS THE CUSTOMERS LOVE

MAZDA 323
$8,299

SUBARU STATION WAGON
$9,208

CADILLAC BROUGHAM
$22,637

WHICH ARE the world's most satisfying cars to own? Arguably, the ten shown here. For automakers everywhere, the U.S. market is not only an important sales arena but also the great laboratory of consumer opinion. Nowhere else do as many makes joust fender to fender for car buyers' attention. To find out what owners think, carmakers turn to the J.D. Power & Associates market research firm. Each August they eagerly await the publication of Power's Customer Satisfaction Index; this year's version reflected over 21,000 owners' views about their experiences. The final index is the aver-



MARK SENNET—ONYX

age of two subindexes, one for technical quality and the other for dealer service.

The Japanese, of course, dominated this year's top spots, but there were some surprises too. Money does not necessarily buy happiness: Half the top ten cost less than the average of all cars sold in the U.S., $12,621. Mercedes, which surrendered first place last year to Honda after leading for four years, fell to third. Reliability problems hurt, particularly with the 190 series. Mercedes' service continued to get high marks—but the highest went to Acura, Honda's venture into the high end of the market, which claimed top spot its first year out. Service was hailed by more owners of the Integra than the $20,250 Legend, but both groups were delighted. Both also proclaimed their cars very reliable.

The companywide rankings of Detroit's Big Three show that new models can still make trouble. Ford, first last year, fell to third because of multiple problems with the acclaimed Taurus and Sable. Chrysler took the lead, leaving GM in the middle again.

Good service can go a long way toward redeeming a troublesome car. Cadillac owners reported woes with fit, finish, and mechanical parts. But because service departments excelled in being helpful, courteous, and understanding, Cadillac vaulted from 14th place on last year's list to seventh—the first GM car to make it into the top ten. Conversely, BMW skidded from sixth to 11th because owners reported a falloff in helpfulness, courtesy, ease of getting an appointment, and quality of work.

But the survey results have limits. Power thinks BMW's lapse may reflect booming sales that have overtaxed dealers. And despite it all, Power adds, BMW folk are "much more satisfied" than owners of competing makes. Car ownership is at least partly a love affair for many drivers, and such people are willing to forgive a lot if the flame still burns bright. **—Stephen J. Madden**

THE U.S.: TEAM AT THE TOP OF NO. 2

■ A rumor has been circulating around Detroit for several months that Ford Chairman Donald Petersen, 61, will take early retirement so that Vice Chairman Harold "Red" Poling, who is 11 months older, can move up to chief executive officer before he retires too. Petersen swears he has no intention of retiring early, but the rumor points up the unusual degree of respect and cooperation between the two men.

Petersen and Poling are exemplars of Ford's new breed of manager. Both held big jobs overseas before landing top posts in the U.S. Petersen ran all of Ford's international automotive operations in the late 1970s, while Poling served as head of Ford's European activities for five years until 1980. They also are the prime movers behind the team spirit that has overtaken the company since the man with his name on the building, the late Henry Ford II, stepped down as chief executive in 1979.

Working together, Petersen and his red-haired colleague had a hand in Ford's first attempt at building a "world car." The effort foundered because the demands of European customers (small engines, high fuel economy) could not be melded with the wishes of American buyers (bigger engines, more optional equipment). But the project was the forerunner of the company's new policy of parceling out engineering assignments to separate "centers of excellence" on three continents.

In 1980 Petersen and Poling returned to the U.S., where Petersen was named company president and Poling got the job of reviving Ford's troubled North American operations. As the company's two top executives, they have done their jobs so well that Ford will make more money than GM and Chrysler combined this year, and Ford division cars and trucks have passed Chevrolet's as the biggest-selling individual brand.

DANA HEMAN—SIGMA

Petersen (left) and Poling shaped Ford's world thrust.

At Ford's world headquarters, the two occupy adjacent offices and try to have lunch together once a week. Poling concentrates on operational matters, while Petersen focuses on strategic issues. In addition to desk time, both men spend at least four hours a month guiding cars around Ford's Dearborn test track to evaluate engines, transmissions, and suspensions. They were the first Ford executives to graduate from Bob Bondurant's four-day performance driving course in California in 1982—a cram course in how to handle a car at high speeds and avoid accidents—and have been encouraging others to follow in their skid marks. Poling, a finance man by training, says, "It really helped me to learn about our products, to the point where I can now make suggestions to improve them."

Around the company, the taller Petersen is known as "Mr. Outside" for his unruffled behavior before large audiences, while Poling, who is considered fairly shy, does better in smaller settings. Poling is the more competitive of the two. Though he tore up a knee while playing college football, he is an active golfer with a 7 handicap. Both are collectors: Petersen of minerals and jazz recordings, Poling of fine wine.

With Ford running as smoothly as an eight-cylinder engine, a current concern for both men is picking their successors. The odds-on candidate for chairman is Allan Gilmour, 53, recently made head of international operations, while Philip Benton Jr., 58, who now runs the worldwide auto business, and Louis Ross, 55, the North American boss, are the leading candidates for the No. 2 job. Handicapper's tip: Look for two more men who can work as a team.

Honda's lack of linkups is chance, not design. More likely it is an outgrowth of Honda's yen to chart its own course. Says Nobuhiko Kawamoto, president of Honda Research & Development: "We keep destroying our organization and keep rebuilding it. We have to have flexibility and energy."

Do such developments mean that being big is now a disadvantage? So holds the preponderance of conventional wisdom today, and GM's travails seem to offer proof. Smaller companies, the reasoning goes, are leaner, more efficient, and quicker to respond to change. Even in developing new technologies, they are perceived to be more effective. Andrew Graves, another MIT analyst, points out that GM invested $3.7 billion in R&D in 1985 and won some 300 patents. Honda spent only $670 million, but also got about 300 patents.

But the problem may not be size itself as much as GM's failure to capitalize on it effectively. Toyota, considered the world's most efficient automaker, is no pygmy. It buys an estimated 80% of its parts from its own or captive suppliers. It simply manages the arrangement better. It is also quick on its feet and fast to respond to changing market conditions.

And while some advanced technology can be bought off the shelf—antilock braking systems, for example, which can bring a car to a stop on slippery surfaces without throwing it into a skid—car buyers are more attracted than ever to the company that is the first with the newest. It will probably take an automaker with deep pockets and plenty of technical expertise to produce the next major breakthrough in engine design or body assembly.

The strategies that the world's automakers adapt for the future reflect in large measure the companies' own current strengths and weaknesses. Ford, which has long thought of itself as an international company,

EUROPE: A BATTLING BUREAUCRAT

■ An unlikely executive is driving an improbable company to a spectacular turnaround that has left rivals amazed and anxious. Under the guidance of Jacques Calvet, a former bureaucrat, Peugeot, the former basket case, has almost caught Ford, capturing 11.8% of the European market. That puts it in fourth place behind Fiat, Volkswagen, and Ford. Nearly bankrupt when Calvet took charge in 1984, Peugeot should earn almost $1 billion this year; the company's stock has risen more than sixfold since 1985, to $273 a share.

For an auto magnate, Calvet, 56, is remarkably homespun. He works in a tiny office equipped with worn wooden furniture. His secretary sits 20 yards down the hall; executives frequently spot the boss jogging down to see her. Tall and wiry, a shock of brown hair tumbling over his forehead, he wears rumpled wool suits even in summer. Calvet has been known to get down on his knees in Peugeot showrooms to inspect the metallic finish on a car's rocker panel. The auto business, he claims, is a labor of love: "It requires me to be both a manager and a poet."

AGNES BONNOT—IM

Calvet aims to lead Europe.

A graduate of the Ecole Nationale d'Administration, France's top school for civil servants, Calvet rocketed to the top of the bureaucracy, serving in the early 1970s as the chief aide to Finance Minister Valéry Giscard d'Estaing, later President of France, and then as head of a state-owned company, Banque Nationale de Paris. He was sacked in 1982 by the newly elected Socialist government. Calvet then joined Peugeot, the privately owned producer of Peugeot and Citroën automobiles. Racked by heavy debts, crippling strikes, and a bloated work force, Peugeot lost $443 million in 1983. It did not help that the Socialists were zealously protecting jobs. When Calvet demanded government approval to eliminate 7,400 workers at an auto plant near Paris, the Socialists insisted that Peugeot reduce its 40-hour workweek to 39 hours in exchange. Calvet refused and eventually won the showdown, inspiring dozens of French companies to cut costs through layoffs.

This year Peugeot will turn out 1.8 million cars with 165,000 workers—100,000 more vehicles than it produced in 1981 with 218,000 employees. Peugeot and Citroën once manufactured separate lines of parts in separate, outmoded plants. Today robotized factories churn out motors, gearboxes, and other components for both lines, a shift that has enabled the company to close five components factories since 1984.

Calvet plans to make Peugeot No. 1 in Europe by turning it into the only European automaker with two full lines of cars: four models each of both Citroën and Peugeot, ranging from subcompacts to luxury sedans. But his ambitious plans face a new roadblock. In August the French government announced it would write off $1.5 billion to $2 billion of its loans to Peugeot's stricken state-owned rival Renault in preparation for eventually privatizing it. Without the write-off, the government argues, Renault would be bankrupt once it left the government. But Calvet regards the write-off as an outrageous subsidy that would give Renault an unfair competitive advantage, especially since the government has yet to set a date for privatization. In September he suggested he might quit if the bailout goes through. "We were in deficit too," Calvet argues. "But we pulled ourselves out without the aid of the taxpayer." The government is now reconsidering the write-off. Nobody relishes a battle with bureaucrats like former bureaucrat Jacques Calvet.

— Shawn Tully

is trying to capitalize on its European assets. Spurred by Chairman Donald Petersen (see box, page 82), who used to run Ford's overseas operations, it is using design centers in the U.S., Britain, and West Germany to develop a single worldwide replacement for two cars: one sold in the U.S. as the Ford Tempo and Mercury Topaz, and the other, the Sierra, manufactured in Britain and Belgium. Duties in the project, code-named CDW27, have been painstakingly divided. The door frame of the new car will be designed in West Germany; the moving parts for the door will be crafted in Britain. Teams of engineers in Britain regularly board a plane for the 90-minute flight to Cologne for conferences with their German counterparts, and vice versa.

GM, which builds 73% of its cars in North America, traditionally has encouraged little interaction with its overseas subsidiaries. So Detroit has sole responsibility for North America, while Opel designs all GM cars sold in 15 other countries. Says Paul Bausch, an Opel engineer: "It gives us much better efficiency to do development work under one roof." Divisions between the two continents are crumbling, but slowly. GM wants to import two Opel models for sale in the U.S., but Opel officials are not keen on selling them through GM's dealer network.

THE JAPANESE scare everyone. Says Peter Slater, an international strategist for Ford: "Toyota is our No. 1 competitor. It is far more dangerous than General Motors. And if Honda keeps improving the way it has over the past ten years, we'll all be pressed to keep up with it."

Yet the strategies of the major Japanese players are simple. Toyota, with its massive assembly complex near Nagoya, a two-hour ride by high-speed train from Tokyo, essentially builds one version of each model at home and ships it all over the world. Since Honda's production facilities in Japan are taxed to capacity, it has been far more aggressive in building U.S. plants, but it still makes the same car in both places. Soon those American-built cars will be shipped overseas to Europe and Japan as well.

By the 1990s any company that survives will have to make cars that are up to the standards of the hotly competitive world market. The title of low-cost producer will shift from country to country, depending on who benefits the most from currency swings. So the future will belong to those who can master the

JAPAN: HANDS ON AT HONDA

■ Honda Motor is most noteworthy these days for aggressive strategic moves—its overseas expansion and bold assault on the luxury car market. But the company originally made its mark through obsessive attention to the design of its cars, and that obsession is embodied in President Tadashi Kume.

In keeping with Honda's freewheeling corporate culture, Kume delegates heavily to his lieutenants. For example, Tetsuo Chino, president of Honda North America, is generally credited with planning a second plant in Ohio and developing the phenomenally successful Acura line. But Kume still loves engineering and is a hands-on manager by nature, so he spends much of his time visiting plants, suppliers, sales outlets, and research labs, grilling everyone from engineers to customers on what buyers want and how the company can give it to them. Workers sometimes grouse about his nitpicking, says Toru Teshima, president of Stanley Electric, a supplier, "but he understands the needs of engineers."

Referring to Thomas Alva Edison's dictum that "genius is 1% inspiration and 99% perspiration," Kume says, "I perspire 99.9% of the time." He put his career on the line in a 1968 showdown with the company's legendary founder, Soichiro Honda. As the young chief engineer of R&D, Kume insisted that the cars Honda was planning to build should be outfitted with water-cooled engines, which would be cleaner and quieter than the air-cooled ones Honda favored. The founder was adamant, so Kume submitted his resignation. In the end Honda came around, and Kume returned.

As a child in the port city of Kobe, he was fascinated by ships, planes, and trains, and built ship models from chopsticks and paper. At Shizuoka University, where he majored in mechanical engineering, he managed only a C in math but was a genius at mechanics. Students in the auto club called in Kume when their tired Dodge sedan broke down. Still, he failed the entrance exam of a major automaker because of his poor knowledge of metals. A professor introduced him to then fledgling Honda, which he joined in 1954.

One of Kume's earlier assignments was to design an engine for Honda's entry into Formula II car racing. The first versions broke down constantly—not uncommon for a new racing machine. Kume commuted between Japan and the European race circuits, heading straight from the airport to the lab when he got home to toil around the clock and sleep in his office. Within half a year he had perfected the design, and Honda won 11 of the 12 races it entered.

Kume went on to design more than 30 engines, including the famous low-emission CVCC engine that helped make Honda's name in the U.S. In the days before computer-aided design systems, Kume stored engine plans in his head as he worked. Arms folded, he would sit and stare all day at a chalkboard, working out a basic concept that he would later commit to paper. Nobuhiko Kawamoto, head of Honda's R&D, says, "I don't know of anyone in the world who is greater at machinery design than Kume."

GEORGE SINEZ

An engineer at heart, Kume sweats the details.

Kume's declared aim these days is to triple Honda's already high productivity. That's an astounding ambition, made doubly astounding by his assertion that he is close to achieving it. Neither he nor other Honda officials will elaborate, but whatever the actual goal, rivals had best pay close attention to what this passionate manager sets out to do.

—Frederick Hiroshi Katayama

arts of styling, marketing, and image building.

They will undoubtedly be taking their cues from the West German luxury car manufacturers, the world leaders in image marketing. You pay more for a British Rolls-Royce or an Italian Lamborghini, but Mercedes-Benz is the world's standard. The 600,000 cars it builds each year are more or less constantly in demand, despite complaints about the quality of its lowest-priced line, the 190 series, and about Mercedes prices ($27,430 to $70,600 for U.S.-equipped cars). Just now, smaller BMW is giving Mercedes a stiff fight for bragging rights. Its 12-cylinder 750il, which will sell for more than $65,000 in the U.S., beat Mercedes' new big cars to market by a year or two, and auto buffs consider them the *crème de la crème.* Sniffs Gunter Kramer, president of BMW of North America: "We're very small and very careful to remain unique. Mercedes is in the fleet and taxi business."

In trying to limn the outlines of the future, it is prudent not to discard entirely the conventional wisdom of the past. Another oil shortage and price spike could create some of the same conditions in the early 1990s that produced the dire predictions of the late 1970s. Even without one, the long-run outlook of several automakers remains in doubt. Though a nimble marketer, Chrysler lacks the capital to develop new engineering. Britain's Rover Group and France's Renault are wards of the state. As Toyota, Nissan, and Honda continue to strengthen, less room is left for such Japanese bit-part players as Daihatsu, Isuzu, Subaru, and Suzuki.

AS IMMENSE as auto companies are, they can rise and fall remarkably quickly. Several that survived into the Seventies disappeared in the Eighties: France's Simca and Talbot, Britain's Rootes Group and British Leyland, and the U.S.'s AMC. Hyundai, on the other hand, vaulted from nowhere to become America's No. 6 import. Thriving BMW was a struggling maker of sporty but modest sedans just 13 years ago.

Don't underestimate the potential for surprising turnarounds. In the early 1980s experts foresaw the U.S.'s Big Three becoming a Big Two—or even a Big One. Then GM tripped over its shoelaces, while Chrysler came back from the brink and Ford scored an unexpectedly big success with the Taurus and Sable, assuring itself a major role into the Nineties. Any one of today's troubled automakers could pull off such a reversal. Even GM. ■

TOUGH TIMES LIVING WITH TAX REFORM

Business is wrestling with confusion over last year's sweeping tax changes while it awaits a "technical corrections" bill that could be longer than the act itself. ■ *by Kenneth Labich*

ONE YEAR after Congress passed its sweeping tax reform, businesses across the U.S. are only beginning to grapple with the law's dizzying effects. Companies of all types and sizes have had to change their way of doing business as they try to cope with complex new regulations and, on average, much higher tax bills. The full effects of tax reform on the economy are still unknown, but one result is abundantly clear: It has enormously complicated corporate financial and investment planning. Since many of the new rules are vaguely drawn or subject to interpretation, accountants and financial officers often can only guess at the tax consequences of some major corporate maneuvers.

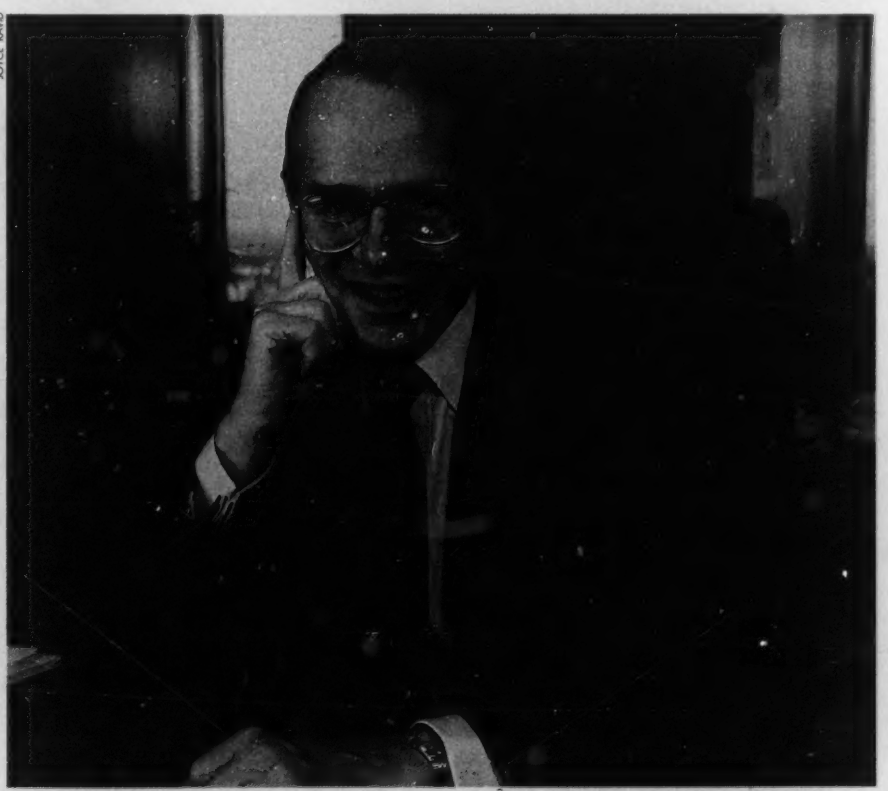
Unsurprisingly, businessmen who opposed tax reform during its gestation say the new baby is a monster, while the relative handful of corporate proponents insist that it will be a tonic for the economy. Most executives fought reform because Congress took away the cherished tax credit of up to 10% for investment in capital equipment and at the same time stretched out depreciation on many types of plant and equipment. Congress gave back some of the extra revenues generated by those changes by cutting corporate tax rates. The top rate on corporate profits dropped from 46% to 40% this year and goes to 34% in 1988. But about half the revenues from the elimination of corporate tax breaks went to finance the reduction in personal tax rates. The net result was roughly a 22% hike in corporate taxes, an increase of $120 billion over five years.

Robert E. Mercer, chief executive of Goodyear, echoes the bosses of many other capital-intensive manufacturing companies when he grouses that tax reform will stifle investment and productivity growth. "If we were planning a bill that would increase U.S. competitiveness," says Mercer, "it would be the opposite of this." George M. Keller, Chevron's chief executive, is even more caustic: "I call it tax *de*form. It's a terrible step backwards."

Among the business defenders of reform, none has been more enthusiastic than John H. Bryan, chief executive of Sara Lee. Like most advocates of reform, Bryan argues that the changes will promote economic growth because the investment tax credit (ITC) and other special breaks that Congress eliminated had been distorting capital allocations. Now that corporations are taxed much more equally, investment should flow to the most

REPORTER ASSOCIATE *Edward Prewitt*

JOYCE RAVID



"For God's sake, leave the tax code alone. It's not fair. It's not equitable. But leave it alone anyway so we can get on with financial planning."

ROBERT C. WINTERS—*Chief executive, Prudential Insurance Co.*

productive uses rather than to those most favored by the tax code.

In fact, the net effect of tax reform is unknowable in advance, and it may be impossible to measure even after the law has been in place for years. Economists who specialize in tax theory generally agree that getting rid of provisions like the ITC is a big plus. If Congress had used all the revenues gained by closing those loopholes to finance a bigger cut in corporate tax rates—and left total business taxes unchanged—reform almost certainly would have been a boon to the economy. But saddling business with an extra $24 billion a year in taxes is a big minus. And no amount of theorizing or econometric modeling can determine for sure whether the boost from reducing tax distortions is enough to offset the drag from higher corporate taxes overall.

THE IMMEDIATE EFFECTS of tax reform, on the other hand, are already apparent. By FORTUNE's estimate, pretax corporate profits will jump more than $20 billion this year, to $247-billion. But after-tax profits will drop by about $2 billion, to $122 billion. The punch to capital spending is even more dramatic: Outlays on plant and equipment dropped last year, when the repeal of the ITC took effect, and they are falling again this year. Business investment amounted to 12.6% of GNP in 1985 and will reach only 11.6% this year.

Companies have been running into plenty of unpleasant surprises—and some unintended ones—as they adapt to the new rules. One change is a much stiffer minimum tax. Corporations now have to pay the IRS at least 20% of the pretax profits they report to shareholders, even if the separate set of books they use to compute profits for the government shows they owe much less. That rule was designed to "catch" thriving outfits like General Electric that exploited old provisions in the code so adroitly that they ended up paying no taxes at all.

But the minimum tax also is catching some companies that should escape, even under the new ground rules. Bank of New York, for instance, is adding $135 million to its loan-loss reserves this year, mostly for possible write-offs of troubled Third World debt. The new reserves will be deducted from publicly reported profits this year. But Bank of New York will not be able to take the deduction on its tax return until next year or later, when it will actually write off the loans. Result: Profits reported to shareholders probably will be back up next year, taxable profits will be much lower, and Bank of New York probably will pay the minimum tax.

GEORGE STEINMETZ

"There is a tremendous amount of unsureness in planning now. I ask my accounting people about some ruling, and I get a 'worst scenario' answer."

GEORGE M. KELLER—*Chief executive, Chevron Corp.*

The tax experts at Goodyear are still puzzling over exactly how tax reform will alter the company's long-range plans. The company's accountants did a study of one recent expenditure, the $250-million refurbishing of a plant in Tyler, Texas, and concluded that the investment probably would not have been sufficiently profitable under the new code.

The accountants say "probably" because figuring out the true economic benefits of any big project has become far more complex. Assistant controller Ronald C. Houser says that when top management wants to know whether to build a new plant, his staff must now perform a series of calculations to account for the new minimum tax, for new rules governing the taxation of foreign income, and for regulations that require a more complete accounting of inventory costs. "We end up doing four or five times the work," says Houser. "And the economic benefit to the company may still be unclear."

The tax crew at Chevron also is reeling over fresh complexity and ambiguities. Chairman Keller fumes that the law is so convoluted that it makes financial predictions impossible: "There is a tremendous amount of unsureness in planning now. I ask my accounting people about some ruling, and I get a 'worst scenario' answer." They aren't kidding. It will be years before the IRS and Treasury decide on the final rules to implement what Congress mandated in the 1986 act. Emil M. Sunley, director of tax analysis at the accounting firm of Deloitte Haskins & Sells and former deputy assistant secretary of the Treasury for tax policy, notes that it takes the IRS about three years to issue regulations on major provisions of tax bills. It *never* writes all the rules needed to enforce

the changes Congress dictates. Keller was particularly riled recently when his accountants couldn't tell him how the IRS will now treat the interest payments on the company's $7-billion debt.

UNDER THE OLD LAW, interest on that debt was almost fully deductible. But companies now have to allocate some of their interest expenses to foreign income. They deduct the "foreign" interest from foreign profits to calculate how much they can claim in credits for taxes they pay abroad. Since the interest charges reduce foreign profits, they also reduce allowable foreign tax credits and thus boost U.S. taxes.

But by how much? Chevron's financial officers, no slouches at their job, cannot figure out how much of the company's debt will qualify for a deduction in the U.S. and how much they will have to allocate abroad. Congress may fix this and other glitches in a "technical corrections" bill. That bill has been in the works for a year and probably is still six months or more from completion.

The grumbling is equally loud at Du Pont, even though the company may actually pay less taxes this year than it would have under the old code. Earnings are up so sharply that the drop in corporate tax rates may more than offset the loss of other breaks. But company officials are still annoyed. William Resnick, director of Du Pont's tax division, says Congress erred grievously by leaving much of the rulemaking to the Treasury and the IRS. He says they are prone to overlook fairness and resolve all questions so as to produce more revenue.

Even if a company operates under that pessimistic premise, Resnick says, it still cannot predict the ultimate outcome of any major dispute with the government tax collectors because of the new law's complexity. He specifically cites the increased accounting load brought on by the minimum tax, almost indecipherable foreign tax provisions that break up corporate income into various "baskets" that are taxed at different rates, and "uniform capitalization" rules that require new inventory valuations. Says Resnick: "I maintain that this bill is unauditable."

> "What's grossly unfair is paying taxes according to the ability to lobby Congress. Some statesmanship has finally come out of Washington."

Financial service companies are finding lots to complain about as well. Prudential and other life insurers do not benefit greatly from the lower corporate tax rate because Congress had already cut their rate to 36.8% in 1984. Instead the Pru will get smacked by the increase in the corporate capital gains rate from 28% to as much as 34%. And the repeal of the ITC will cost Prudential about $35 million this year. Says Chief Executive Robert C. Winters: "If your objective is capital formation, then heavy taxes on life insurance companies isn't a very good idea. If your objective is to pluck geese, then you pounce on the first gander that comes along."

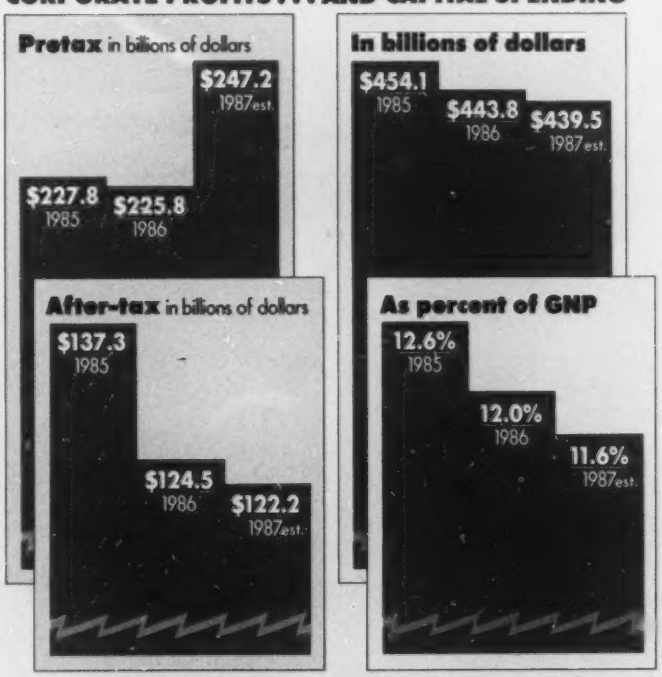
New complexity in the treatment of employee benefits such as pensions, health insurance, and life insurance also troubles Prudential. The company has three divisions that administer benefits for other employers, and it will have to pass along its increased costs to customers. Jeremy Judge, Prudential's assistant controller, says that new rules governing benefits require so much extra documentation that Prudential has been forced to design entirely new programs for some customers. Says Judge: "The complexity is such that we don't know exactly what's going to happen—what to plan for ourselves and what to sell to other companies."

THE WINNERS under tax reform have a decidedly different fix on the new regime. Bryan of Sara Lee says the new law will have only good effects for his company and its customers. Sara Lee will pay lower taxes this year than last, and Bryan says it will pass the savings along to pastry lovers in the form of lower prices. Brushing aside the complaints about complications and confusion, Bryan argues that reform has rechanneled the energies of many American businesses from seeking shelters to more productive enterprises. He quickly dismisses arguments that the new code is essentially unfair in some respects. "What's grossly unfair is the concept of various industries paying taxes according to their ability to lobby Congress," he says. "Some statesmanship has finally come out of Washington."

Though less fervid than Bryan, Hewlett-Packard's chief executive, John A. Young, is another backer of tax reform. Like many high-tech companies, Hewlett-Packard has relied far less than big capital-goods producers on investment credits and accelerated depreciation. So the drop in basic rates more than makes up for those changes. "On balance the situation is much more favorable," says Young. "It's had a considerable benefit on our cash flow."

Young sees little merit in complaints from basic industries about lost benefits. "If we have capital-goods problems, they ought to be taken care of in some other way," he says. But when it comes to an issue much

TAX REFORM HITS CORPORATE PROFITS . . . AND CAPITAL SPENDING



The heavy burden *that Congress shifted to corporations last year is showing up in lower after-tax profits, despite higher pretax earnings. Capital spending is down largely due to repeal of investment tax credits.*

closer to home, tax credits for spending on research and development, he takes an entirely different view. Says Young: "It's one of those things I separate from a tax loophole because it really is good industrial policy."

Since R&D credits remain largely intact under the new code, Young has been able to boost his research spending from about 10% of sales to about 12%. But he, too, has a gripe about the new computation of foreign profits. Like interest, some R&D expenses must be allocated to foreign operations, depriving the company of some of its R&D credits. Young wants that reform re-reformed.

NONFINANCIAL service companies made out the best under tax reform, and few better than Ryder System, the Miami-based company that leases and maintains trucks and aircraft. Ryder lost the ITC on new purchases for its armada—but so did its customers, who are now recalculating their lease-or-buy decisions. Many are finding that some aspects of reform, including the minimum tax, make leasing look better than ever.

By cutting the top personal tax rate below the corporate rate, Congress made double taxation of profits more punishing than ever.

Ryder's leasing business will be up more than 20% this year. To meet soaring demand, the company is adding 15,000 trucks to its lease fleet of 53,000. Ryder has exploited its advantage to the fullest, sending salesmen into the field with computer programs that show customers exactly how much they can save by leasing.

Many small businesses have been startled by tax reform's impact on their operations. Some companies that financed their operations with tax-exempt industrial revenue bonds have had a particularly rude surprise. Beginning in 1982, some banks began putting clauses in industrial revenue bonds that called for higher interest rates in the event Congress cut corporate tax rates. That's because a lower tax rate reduces the equivalent after-tax yield on the bonds. About $15 billion of industrial revenue bonds issued between 1982 and 1985 have such clauses, and the interest on them is going up by as much as three percentage points. In other words, tax reform has saddled the companies that borrowed via the bonds with an extra $300 million a year or so in interest costs.

Owners of small companies also have to rethink how they want to organize their business. By cutting the top personal tax rate below the corporate rate, Congress made the double taxation of profits more punishing. In the past the lower corporate rate acted as a sort of tax shelter for owners of profitable, growing companies. They could pay tax at the corporate rate instead of the higher personal rate and then reinvest the after-tax profits in the business. Now it pays them to escape the corporate tax altogether if they can, and pay at the lower personal rate.

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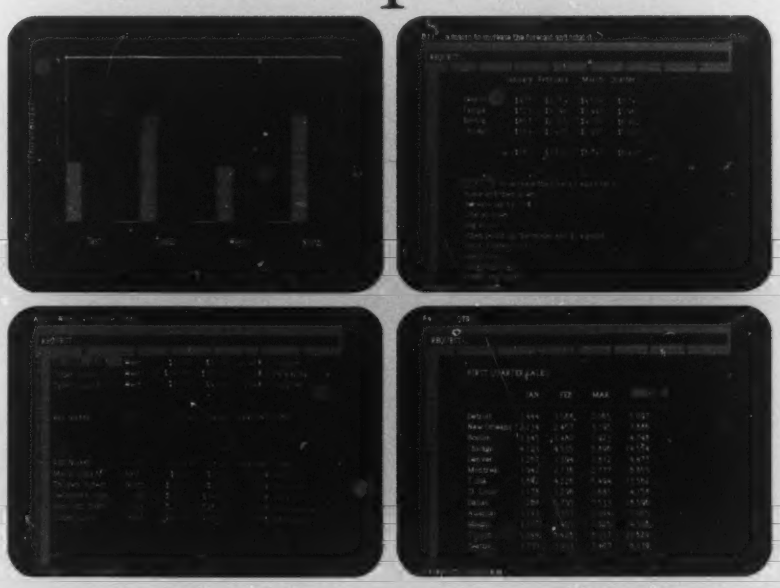

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Some companies do that by organizing themselves as so-called subchapter S corporations, which are taxed like partnerships. In the past year, many others have escaped corporate taxes by converting to what are known as master limited partnerships. But Congress wants to shut off that escape route. A tax plan that has been approved by Democrats on the House Ways and Means Committee would eliminate the master limited partnership option for active businesses (as opposed to "passive" businesses like real estate partnerships). The tax package, designed to raise $12 billion of new revenues, almost certainly faces a Reagan veto if it passes in the House and Senate. But master limited partnerships might also get hit in the technical-corrections bill.

Peggy Duxbury *of the National Association of Manufacturers cites compliance nightmares.*

THE NEW TAX ~~CODE~~ clearly is fairer than the old one, both for corporations and individuals. Once it is fully phased in, the taxes paid by individuals or corporations with similar incomes will be much more equal than before. But that fairness has come at the cost of a numbing increase in complexity, especially for corporations, but also for individuals unlucky enough to have large amounts tied up in tax shelters.

Many experts, including Peggy Duxbury, director of taxation at the National Association of Manufacturers, believe that Congress must radically simplify the tax code, and soon. Says Duxbury: "Businesses are spending huge sums of money to hire new accountants and work up new computer systems, just to have the auditors reverse everything two years down the line." The added costs of complying with the rules are just as much a tax on business as the checks companies send to the IRS.

Yet the most sensible approach may be to do nothing at all right now. After wrestling with four major tax bills in six years, even some of the staunchest opponents of reform are calling for a period of benign neglect. Says Winters of Prudential: "For God's sake, leave the tax code alone. It's not fair. It's not equitable. But leave it alone anyway so we can get on with financial planning."

That doesn't seem likely. Says Emil Sunley of Deloitte Haskins & Sells: "There's a tremendous industry that has built up in Washington simply monitoring the changes in the tax law and proposing new ones." So for a while at least, it seems that death will be the only certainty. F

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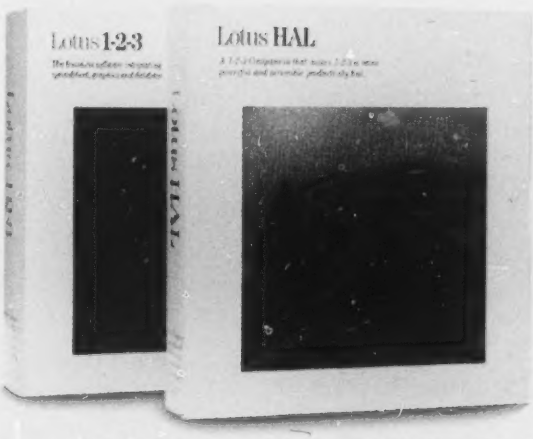

Besides all this, Lotus HAL allows 1-2-3 to audit spreadsheets for possible errors, and link cells or ranges between worksheets.

One obvious benefit of all this is that you save time. Which means you're more powerful, more productive, more effective than ever before.

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You see? Everything with Lotus HAL begins with a simple request. Lotus HAL

*Suggested Retail Price (Plus Sales Tax)

Requirements: Lotus HAL is a memory-resident program that requires 1-2-3 Release 1A, Release 2, or Release 2.01 (5.25 or 3.5 inch disk version) for personal computers from IBM,* COMPAQ and AT&T, plus 1-2-3 certified compatibles; two disk drives; DOS 2.0 to 3.3; 512K RAM. Please refer to your 1-2-3 package or 1-2-3 documentation for appropriate hardware configurations and DOS requirements or consult your dealer. *Lotus HAL does not operate with Release 1A for the IBM PCjr., or for the IBM 3270PC. When you purchase Lotus HAL directly from Lotus, take your first 30 days to try it. If after 30 days, Lotus HAL does not perform as described and you've purchased it directly from Lotus, we'll gladly give you a full refund. © 1987 Lotus Development Corporation. Lotus and 1-2-3 are registered trademarks of Lotus Development Corporation. Lotus HAL is a trademark of Lotus Development Corporation.
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AMERICA'S BEST-RUN CHARITIES

The key clue: How much does your favorite cause spend on programs instead of overhead? ■ *by Gwen Kinkead*

ROSS PEROT is giving away his $2.5-billion fortune. He says it is all going to charity, "the best and highest use." Over the past two decades he has parted with more than $100 million, and in the process has learned that while good causes are easy to find, good management is not. With customary pith, Perot tells how to judge charities: "The whole trick is to figure out which deliver results, which have leadership, and which are using the money for the people who need it, as opposed to chewing it up in overhead, making it disappear in enormous amounts, wasted."

That is a workable rule for anyone trying to identify charities worthy of support, at a time when the need for private generosity is increasing. Cuts in federal and state funding have left large—and increasingly visible—gaps in the social welfare net that private agencies are struggling to mend. Perot's sister, Bette, who has charge of his foundation, reports, "We are under siege here in Dallas with requests for help," particularly, she adds, for food and shelter needed by the homeless and poor.

Charities dealing in health and social service causes—some 135,000 in all—are sending out mail and telephone solicitations as never before. In an extreme example, a Virginia businessman had his dinner interrupted seven times by phone calls asking for donations. The appeals will increase. The Independent Sector, a Washington-based coalition of corporations, foundations, and charities, is calling for a doubling in the next five years of the $87 billion a year that fund-raising drives now bring.

Not all the charities mounting drives are well known or national. Typical of many local charities is Pegasus (see picture below), a 12-year-old program in Darien, Connecticut,

Riding horses *provided through Pegasus, a Darien, Connecticut, charity, helps cerebral palsy victim Ashley Milne, 5, toward health—and joy.*

SYLVIA PLACHY

that helps disabled children and adults regain balance and coordination through horseback riding. Most of Pegasus's 150 "clients" have brain damage, usually from birth injuries, accidents, cerebral palsy, or stroke. The innovative program, run mainly by volunteers, raises $90,000 a year to provide free riding lessons at eight stables in Connecticut and New York.

WHICH CHARITIES are well managed and deserve your money? The best benchmark—useful but not infallible, because of the differences in needs served and services offered—is the percentage of revenue an organization spends on "program," or the good works for which it was established (see table). There is no magic figure for spending on program vs. overhead and fund raising. And the Supreme Court has ruled that states may not establish fund-raising benchmarks. In 1984 the Court struck down a Maryland law that made it a criminal offense for a charity to spend more than 25% of gross income on fund raising. The Court declared that high solicitation costs are not necessarily an indication of wrongdoing.

Two watchdogs that do set ethical and procedural guidelines and review charities for compliance differ on what percentage of program spending is enough. The Council of Better Business Bureaus likes to see at least 50% of income spent on program; the National Charities Information Bureau, 60%. In return for a self-addressed, stamped envelope, both organizations will send prospective donors reports assessing various charities. Write to the Philanthropic Advisory Service of the Council of Better Business Bureaus, 1515 Wilson Boulevard, Arlington, Virginia 22209, or the National Charities Information Bureau, 19 Union Square West, New York, New York 10003.

Movie star–philanthropist Paul Newman sets a more stringent standard in giving away the profit made by his food companies, New-

REPORTER ASSOCIATE *Patricia A. Langan*

CHARITY	TOTAL ANNUAL REVENUES in millions	SPENDING		SOURCES OF INCOME			TOTAL PAID STAFF Volunteers
		PROGRAMS in millions % of total	FUND RAISING, ADMINISTRATION in millions % of total	PUBLIC DONATIONS in millions % change from 1977	GOVERNMENT PAYMENTS in millions	OTHER INCOME in millions	
American Red Cross	**$973**	**$796** 82%	**$76** 8%	**$341** +441%	**$30**	**$602**	**22,100** 1,400,000
Salvation Army*	**$865**	**$740** 86%	**$124** 14%	**$473** +50%	**$92**	**$300**	**29,350** 1,000,000
Unicef	**$463**	**$392** 85%	**$45** 10%	**$67** +179%	**$348**	**$48**	**1,652** N.A.
Goodwill Industries of America	**$447**	**$342** 77%	**$82** 18%	**$42** +206%	**$88**	**$317**	**N.A.** N.A.
CARE	**$397**	**$376** 95%	**$21** 5%	**$45** +125%	**$340**	**$12**	**7,087** N.A.
American Cancer Society	**$308**	**$206** 67%	**$66** 22%	**$271** +138%	**$00**	**$37**	**4,453** 2,500,000
Planned Parenthood Federation of America*	**$274**	**$226** 83%	**$48** 18%	**$67** +191%	**$106**	**$101**	**8,200** 18,000
United Cerebral Palsy Association	**$233**	**$194** 83%	**$37** 16%	**$40** N.A.%	**$156**	**$37**	**N.A.** 2,000,000
National Easter Seal Society	**$212**	**$160** 76%	**$43** 20%	**$83** +86%	**$51**	**$78**	**5,600** 800,000
Boys Clubs of America	**$187**	**$148** 79%	**$40** 21%	**$103** N.A.%	**$9**	**$75**	**3,650** 150,000
American Heart Association	**$179**	**$129** 72%	**$43** 24%	**$151** +124%	**$1**	**$27**	**2,700** 2,300,000
Volunteers of America	**$166**	**$151** 91%	**$14** 8%	**$14** +213%	**$69**	**$83**	**5,000** N.A.
Association of Retarded Citizens of the U.S.*	**$140**	**$108** 75%	**$20** 15%	**$28** +27%	**$80**	**$32**	**5,600** 300,000
March of Dimes Birth Defects Foundation	**$112**	**$82** 73%	**$33** 30%	**$106** +83%	**$00**	**$6**	**1,600** 275,000
American Lung Association*	**$97**	**$65** 67%	**$28** 29%	**$80** +88%	**$0.8**	**$17**	**1,300** 150,000

*Estimated.

How the Money Comes and Goes

The 15 largest charities are ranked by 1986 revenues. Some get sizable income from sources other than donations. Red Cross, for example, earns over half its revenues by selling blood; Unicef sells greeting cards. Government payments are for services, except in the case of CARE, which distributes surplus food. Some percentages do not add up to 100% because of surpluses or deficits. All figures were supplied by the charities.

man's Own (popcorn, spaghetti sauce, and lemonade) and Salad King (salad dressing). In four years he has donated $11 million to 300 charities. He and partner A. E. Hotchner, a writer best known for his 1966 book, *Papa Hemingway: A Personal Memoir*, look for organizations that spend at least 85% of revenues on their programs. Says Hotchner: "If the whole point of your business is to give away money, we don't think you should gobble it up first."

Many of the 15 largest social welfare and health charities listed in our table come within reach of that stringent standard, but only four equal or exceed it. One that does is the Salvation Army. An unabashedly evangelical church, whose officers wear red labels symbolizing the blood of Christ on their blue suits, the Salvation Army aims to restore the self-respect of those who cannot help themselves. Says author Peter Drucker, a consultant to several charities as well as business managements: "The Army probably does a better job with the poor than anyone else. Its achievement is to convert outcasts into citizens." Board member George McCullough, a former Exxon vice president, marvels, "For helping the down and out, there is no one like the Salvation Army people. They stay with it."

And frugally. Of each dollar the Salvation Army receives, 86 cents goes to the needy. One reason for this heavenly record: The Army's troops work for next to nothing. Married Salvation Army officers with 45 years of service, for instance, get only about $12,500 a year per couple in salary. Each couple also receives a grant, which varies with location, of about $9,000 a year to pay federal, state, and self-employment taxes. In addition they get living quarters and, when necessary, the use of a car. In the Army's staff quarters, upholstered furniture must last ten years, and wooden furniture 15 years, before being replaced. The Army refuses to consolidate the finances of its five regional operations, citing the cost of hiring the necessary auditors.

Low-cost labor also helps Project Hope exceed the 85% standard in delivering health care to the developing world. The famous hospital ship is gone, unable to keep up with the demand for Project Hope's services. Its volunteer doctors now work on dry land, training local physicians and nurses. The doctors donate a year or two of their time and receive a nominal wage. They live in quarters provided by the host countries.

PROJECT HOPE spends nothing out of its annual revenues of $37 million on professional fund raisers, outside public relations firms, or paid advertising. Says founder William Walsh, a cardiologist: "Those are the things that eat your money up. We are unhappy if our spending on programs falls below 85% of revenues. After all, people send us money to help the less fortunate, not to help ourselves."

But Walsh also gets unhappy when his organization spends much more than 85% on programs. He finds that running *too* tight a ship makes it harder for Project Hope workers in the field to do their jobs. A certain number of people at headquarters are needed to raise money, organize programs, and be available to help out in emergencies. Says he: "We have been as high as 92% in program, but that's too high. Our people at home nearly had nervous breakdowns backing up the field."

At 95%, CARE outclasses all other big charities in program spending, but for special reasons. It is not a typical charity. The U.S. government donates surplus food and pays some shipping charges, which accounts for 86% of CARE's revenues. Public donations are used to move the supplies inland in poor countries to fight famines, droughts, and other disasters. CARE also digs wells and latrines, builds roads, schools, and small factories, and plants trees to control soil erosion. It excels at all these jobs. Says executive director Philip Johnston: "We strive to have the local government pick up as many of our expenses as possible—for instance, the rent on our offices." Such cajolery cut CARE's costs by $26 million last year, a sum equal to 58% of the $45 million it raised from public donations.

Most charities devoted to health causes do not make the 85% grade, but that does not necessarily mean they are badly managed. By spending more on fund raising, they argue, they increase the pot of money available to support their programs. Few pay medical bills or provide medications. "Frankly, that would be a bottomless pit of costs," says G. Robert Gadberry, executive vice president of the American Cancer Society. Muscular Dystrophy, however, does pay some medical bills and buys certain medical equipment, such as wheelchairs.

The health charities devote large amounts of money to educating the public. The American Heart Association makes no apologies for laying out $73 million last year on its campaign to tell the public and doctors about heart disease, compared with just $55 million for research. Executive Vice President Dudley Hafner credits the informational campaign against hypertension with helping to lower the death rate from cardiovascular disease.

The American Cancer Society, the sixth-largest charitable organization, solicits funds to

At Goodwill in Detroit, *a handicapped worker bags hose clamps for Ford.*

CRAIG BLANK

find cures for cancer, while crusading passionately and effectively against smoking. Last year it spent $44 million on fund raising, $75 million on education, and $81 million on salaries for its staff, while allotting only $77 million to research grants. The society plans to move from New York City to Atlanta to cut overhead; Gadberry says some of the savings will go to medical research.

NOW AND AGAIN a clear-cut case of bad management and fraud makes news. In 1978 the board of CARE appointed an executive director and later discovered that he had pocketed $106,000 of the agency's money. The man returned the money and served ten months in jail. The incident had a useful outcome—under Johnston the agency is now one of the best managed. Formerly a CARE official based in Europe, Johnston hired five new professional managers to back him up. They installed an internal auditor and raised salaries, linking them to job performance—something that was then rare among charities. They also put a professional agency in charge of opening donation-bearing envelopes.

High spending on fund raising and overhead justifies a close look at what's going on, but sometimes the spending seems proper. That appears to have been the case with Farm Aid, which was organized in 1985 by country singer Willie Nelson, a farm boy himself, in an emotional response to the economic plight of family farmers in the Midwest and South. Nelson produced three concerts to raise money to help debt-burdened farmers stay on the land. Such singers as John Denver and Neil Young donated their services, but the concerts were expensive to stage, inspiring criticism in the press. Nevertheless, Farm Aid claims that 62% of the $11.4 million raised by the first two concerts has reached farmers. Proceeds from the third concert, held in Lincoln, Nebraska, in September, are still being tallied. *Variety* quotes Nelson as complaining: "The media are always talking about where the money goes. The money is the smallest part of what we're doing. Farm Aid gives farmers hope."

Father Flanagan's Boys' Home, the formal name for Boys Town, immortalized in a 1938 Spencer Tracy movie, is a charity that in 1986 spent comparatively little of its resources. In addition to caring for 648 orphaned or otherwise disadvantaged boys and girls at the "home campus" near Omaha, Boys Town operates two small campuses in Florida (at Orlando and Tallahassee), a high school in Omaha's inner city, a diagnostic research hospital, and a technical-assistance service for nonaffiliated children's homes. The organization had revenues of some $92 million in 1986, a walloping $64 million of it from a $360-million endowment fund—probably one of the largest of any charitable organization. (Notes the Boys Town annual report: "The Lord has blessed us with an excellent year in the stock market.")

Professional managers are bringing basic business techniques—such as long-range and strategic planning, salary reviews, and market research—to many charities.

Boys Town spent only 35% of its income last year, while continuing to conduct fund-raising drives. The reason is that the Lord cannot be counted on to bless investments year in and year out, and so part of Boys Town's 1986 returns were used to build up the endowment fund for hard times. With its portfolio still prospering this year, the organization is skipping its 1987 drive and plans further expansion of its homes. Boys Town spends $26,000 a year on each child living on the Omaha campus. Father Val J. Peter, Boys Town executive director, says many of the kids there are "severely emotionally disturbed" and require costly care. He adds: "We're the Mayo Clinic of child care. I believe children are to be prized, not priced."

Charities are just now beginning to evaluate themselves. Notes United Way Vice President Russy Sumariwalla: "Charities do not like to be evaluated by anyone. This is a very touchy issue." Now professional managers are bringing basic business techniques—such as long-range and strategic planning, salary reviews, and market research—to many charities. As they straighten out finances and hack at overhead, they spring more money for program.

At decentralized charities such as the American Red Cross, March of Dimes, the American Cancer Society, Planned Parenthood, and the American Lung Association, managers can't easily swing an ax at overhead. The national organizations have no control over costs in their local branches, which are run by independent boards. Since branches also raise funds for the entire organization, executives at headquarters are loath to rein them in—and probably couldn't if they wanted to. Some workers belong to unions, which have a big say in personnel policies.

American Red Cross President Richard Schubert, former vice chairman of Bethlehem Steel, has cut 225 jobs from headquarters but is running into a turf problem trying to cut costs in branches: "It is very frustrating to me that we are not as efficient out there as we should be." March of Dimes board chairman Richard Hallinan, a former general counsel of Combustion Engineering, notes: "You can't move like you can in a corporation. There you can put out a memo to all international and domestic divisions and say, 'Tomorrow we do this.' In an outfit like this, you can't tell a chairman of a local board to do something. They don't work for me. They're not on my payroll. You have to use subtle persuasion. It's a little slower."

Some charities have found that self-evaluation can pay off. Multiple Sclerosis ($43 million in annual revenues, 70% to programs) went through a shake-up in 1982. The board brought in a professional manager and gave the organization's founder and salaried head, Sylvie Lawry, the unpaid position of "founder-director." One of the first things the new manager did was revamp the organization's financial systems. Says board chairman Clifford Goldsmith, former vice chairman of Philip Morris: "Before, they didn't quite know what was coming in, what could come in, and how to classify it. Now we are in great shape." The board boldly asked medical experts to assess whether its research money was well spent. The verdict was favorable, and Multiple Sclerosis is now spending more on research.

BOYS CLUBS, which sponsors educational programs and other activities for disadvantaged boys and girls, is another charity that evaluated itself recently. It hired a pollster to ask its alumni if its programs had helped them. Told by 96% of the living alumni from the 1920s on that the organization had made a difference in their lives, Boys Clubs decided to expand.

Most charities are run by well-meaning people, but not every executive director is a competent manager. The trend toward self-evaluation and professional management can only help charities do better the jobs they were organized to do. Ross Perot may start finding it easier to give away his money. ■